Alexander Funds

The Alexander Perspective

Quarterly Update
December 2022

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CEO's Update

Welcome to the latest quarterly update from Alexander Funds.

I hope you had a relaxing and enjoyable holiday period. After a challenging 2022, it was lovely to spend time with family and friends without the looming spectre of lockdowns or border closures for the first time in two years.

As we move into a new year, the prevailing question for everyone is how far inflationary pressures and interest rates will continue to rise. More significantly, will the effects of the past 3.00% of rate hikes be felt and controlled before it is too late? This central question is shaping our portfolio management as we prepare for what we anticipate to be a volatile credit market environment in the short to medium term.

In response to this expected volatility, we're continuing to lower the risk in our portfolios while preserving solid returns above the cash rate for investors. Our high allocation to floating rate assets continues to benefit both of our funds, with the Credit Income Fund and Credit Opportunities Fund returning 3.35% and 5.03% for the year respectively. In what was a difficult environment for many credit fund managers we are exceptionally happy with these returns.

Alexander Funds has several exciting developments in the pipeline for 2023. We are expanding our team, with two new employees joining us next month, and have recently welcomed Nick Bishop as an independent member of the Investment Committee. Nick is a welcome addition to the team, having worked in financial services for over 25 years and has extensive experience in debt financing and securitisation.

Following investor feedback, we are also working on upgrades to our application process and online investment portal which we hope to launch in the coming months, as well as improvements to the Alexander Funds website to provide easier access to documentation as well as educational content, market updates and portfolio information.

I hope you enjoy reading the update from our portfolio managers in the following pages, covering their overview of the economic landscape and how they are reacting to maintain stability in our portfolios. Thank you for your continued support of the funds throughout 2022, and I look forward to keeping you updated throughout what will undoubtedly be another fantastic year for Alexander Funds.

Warm Regards

Rachel Shirley
CEO

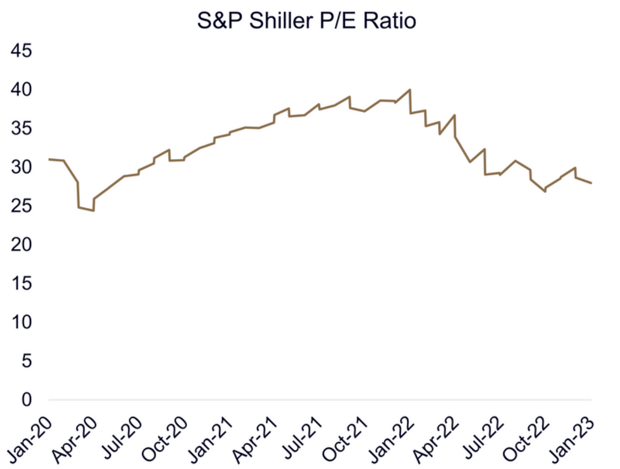
Market Commentary

What happened during 2022?

2022 presented one of the most challenging environments for financial markets seen in decades. Persistently high inflation drove a significant rise in interest rates globally, and expensive valuations after years of historically accommodative monetary policy resulted in significant drawdowns across all major asset classes over the year.

Domestically, the RBA increased the cash rate by 300bps between May and December in one of the most aggressive monetary tightening's ever seen. Europe and the US also undertook similar paths. Meanwhile, both equites and government bond markets began 2022 at very stretched levels, with the S&P Shiller PE trading on ~35x earnings (Chart 1) and the US 10 year bond index at under 1.5% (Chart 2).

Chart 1



Source: Bloomberg

With the direction of equities and government bonds moving from negatively to positively correlated, it left investors with little room to hide, as higher rates combined with deteriorating growth proved almost universally detrimental to returns. While floating rate credit wasn't immune to the macro headwinds, it was a relative outperformer, with the AusBond Credit FRN Index still up 1.3% over the year.

Chart 2

Source: Bloomberg

Where are we focused heading into 2023?

As we enter 2023, the macro trends that dominated 2022 remain in place, with significant uncertainty over;

- Whether the RBA will pause on rate hikes and assess the impact of the 300bps lift over the last 8 months of 2022 or continue to raise rates until a drop in inflation becomes firmly embedded in economic data;
- With a more entrenched inflation problem in the US, how far the Federal Reserve will need to go on interest rates before it can pause; and
- What impact the evolving geopolitical instability in Europe and Asia will directly have on commodity prices, but also indirectly on general investor appetite for risk.

As of January 2023, there is no clear answer to any of these questions and we expect them to provide a heightened level of uncertainty until at least the end of the 1st quarter, although quite likely longer than that.

With this backdrop, some of the key themes and issues we're focusing on when constructing our portfolios include;

Market Commentary

Fixed rate mortgage cliff

At the onset of the pandemic, the RBA created the Term Funding Facility (TFF) to provide, at near zero cost, funding to the banks for up to 3 years. The objective of the program was to provide cheap capital which the banks could then on-lend into the economy to support activity. Given the major banks' business is predominantly residential mortgage lending, most of this cheap capital found its way into the Australian housing market via all-time low fixed rate mortgage offerings, many at or just below 2%.

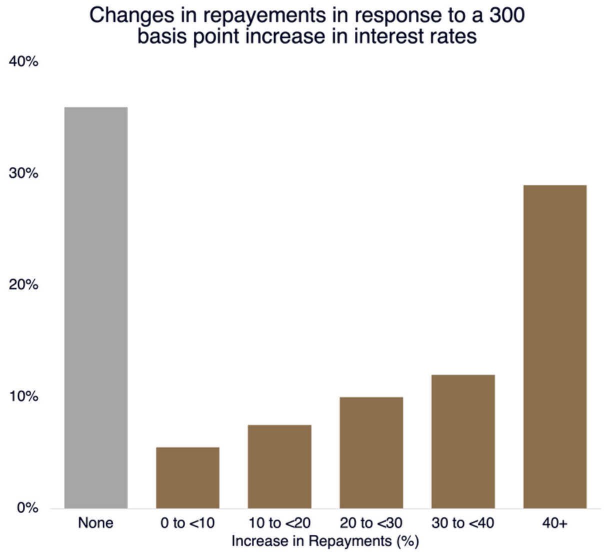
The result was a huge uplift in the use of fixed rate mortgages from Australian borrowers, with the percentage of new mortgages issued as fixed rate over this time being over 70% in fixed from the typical ~15%. The TFF concluded (as planned) on the 30th June 2021 and combined with the RBA stepping back from its 3 year government bond yield curve target in October interest rates, and as a result fixed rate mortgages, began to normalise and then subsequently move higher again as they adjusted to the persistent tightening in monetary policy.

The outcome is that the bulk of fixed rate mortgages issued at this time roll off during 2023, with mortgage holders looking at an immediate 300bps lift in their mortgage rate as a result. By the RBA's own estimate, a third of mortgage holders will end up with a 40% increase in their regular mortgage repayments (Chart 3).

This set of circumstances is significant because it has created an unprecedented delay in the normal translation of monetary policy decision to tangible financial impact for a substantial number of borrowers. This in turn has the potential to cause the RBA to make decisions on data that doesn't reflect the real impact of interest rate rises already implemented.

Our hope is the RBA recognises this when making monetary policy decisions during the first half of 2023 and we remain wary of the impact of them over-tightening.

Chart 3



Source: RBA

Residential property prices

Higher rates have the impact of diminishing an individual's capacity to borrow. A rapid and material rise in rates with no clarity on where it ceases also impacts an individual's willingness to borrow. As both of these are currently true within the domestic market, it should come as no surprise that property prices are under pressure, with a fall of ~10% from the peak already and no sign of stabilisation.

A large portion of the Australian credit landscape is directly connected to residential property, including bonds issued by banks and Residential Mortgage Backed Securities (RMBS). Outside of this, the indirect connection to residential mortgages is also significant given the family home is the key asset on most consumers' balance sheet.

On the face of it, falling property prices should be negative for the credit profile of any security directly linked to residential property. However, this is a blunt assessment and the reality is that taking the time to consider the specifics of each security is vital to understanding its risk. For example, within RMBS the level of seasoning (average age of each mortgage) within a particular mortgage pool is a crucial factor to understanding its exposure to falling property prices.

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Market Commentary

A mortgage pool full of loans written at the peak of the housing market (late 2021/early 2022) has a much different risk profile to a pool of mortgages issued three years ago before the large uptick in house prices driven by lower borrowing costs. Despite this difference, often the market will price the RMBS issued against the two pools in a similar fashion, thereby presenting opportunity for the investor that can analyse and understand the underlying risks.

Liquidity

In constructing portfolios, we consider 4 types of risk;

- Credit Risk – the risk of individual securities being able to meet their interest obligations and repay at maturity;
- Market Risk – the risk the market demands a higher premium and the impact of this change on capital value of securities we hold;
- ESG Risk – the risk that unsustainable Environmental, Social and Governance practices potentially place on the cash flows supporting our portfolio returns; and
- Liquidity Risk – the risk that the portfolio contains insufficient liquidity to meet the demands from our investors.

All four are vital to providing a successful outcome for our investors. However, liquidity risk can often be overlooked, as casual observers of fixed income markets incorrectly assume that the liquidity profile of different market segments remains constant through varying market conditions.

Credit securities (and fixed income broadly) trade via over-the-counter markets. As opposed to shares which trade via a centralised exchange where the price and volume traded is transparent to all market participants, credit securities are traded through a network of market makers and dealers that run trading books and may offer different pricing for the same bonds.

Pre-GFC, most banks ran large trading books to facilitate market liquidity, but also to make money on principal positions.

This model was shown to be systemically undesirable during the GFC as large trading losses on banks' balance sheets threatened the interests of deposit holders. Ultimately this came at the cost of the taxpayer, given most developed world economies have some form of deposit insurance scheme in place. The result was new regulation placing limitations on the size and ability of banks to make markets and hold securities on their balance sheet. While this was appropriate, given banks (especially large ones) are systemically important to the economy, it had the perverse impact of drastically reducing the capacity of the OTC markets to facilitate spikes in trading volumes (such as those that come with heightened volatility). Practically this means that the liquidity within the fixed income market can change drastically and quickly during periods of stress.

As we head into what could be a quite volatile 2023, Liquidity Risk is at the forefront of the team's mind as we consider the appropriate cash holdings within portfolios to weather any volatility, but also be well placed to take advantage of the inevitable opportunities that will present as we move through the turbulence.

When to pivot?

In credit markets, the last 18 months has seen pricing adjust from very expensive to closer to fair value given the economic backdrop. At some point, either spreads will continue to widen (and prices fall) or the economic outlook will improve and make current pricing attractive. While we don't anticipate this change until later in the year, it remains a constant point of discussion about when and to what degree we pivot from the current highly conservative position of our portfolios to accept more market risk.

Factors influencing our decision include;

- Movements in economic data that support an end to the current interest hiking cycle;
- Market pricing continuing to widen to levels that historically represent good value; and
- Clarity that major global economies (particularly the US) have moved through recession and are on a more sustainable footing for growth, but with contained inflation.

Sector Performance & Fund Positioning

Debt Capital Markets

Debt capital markets entered the quarter under pressure as the market's assessment of how high policy rates would need to rise in order to tame inflation continued to grow. Domestically the weaker tone persisted through to mid-November and was supported by a raft of new issuance in the banking space as major banks completed their year-end reporting.

However, once investors had digested the new issues it represented a turning point in spreads as market participants looked to put cash balances to work heading into the end of the calendar year, a period where there is traditionally low issuance. This technical tail wind meant the market consistently rallied over December and provided one of the strongest months seen in Debt Capital Markets in the last 18 months.

Outside of banks and financials, new transactions remained almost non-existent as corporate issuers continued to sit on the sidelines and delay any potential deals until 2023.

Private Assets

Private Debt is a very broad term that refers to a range of separate lending markets. While Alexander Funds has the experience and capability to invest across a number of different private debt markets, the opportunity to deploy capital in private funding warehouses for Non-Bank Financial Institutions remains robust and offers the best risk adjusted return across the full spectrum of our universe. We closed one new transaction in the quarter and have several new opportunities in the pipeline stretching into 2023.

Our origination within the warehouse funding market is focused on investment grade risk, with spreads over cash in the high single digits. This compares very favourably to current pricing in other private debt markets where generating similar return requires investors to accept a significant amount of additional credit risk.

Structured Credit

The domestic structured credit market (primarily RMBS) began the quarter under pressure due to events in the UK.

The well publicised (and derided) Liz Truss "mini budget" had the impact of dramatically re-pricing the UK gilt market as investors rejected the material increase in UK government debt it implied. In a live example of how interconnected global markets are, the fall in UK government bond prices created a liquidity crisis for the UK pension industry, as many had been using products that helped them match their liabilities and assets in a low rate world by effectively adding leverage to their bond holdings. As bond prices fell, they received margin calls on the leverage and thus were forced to embark on a global selling campaign across a range of different asset classes to generate liquidity – Australian structured credit was one of those asset classes.

As a result, the Australian market saw auctions for roughly $1.5bn of securities in the space of a few weeks, well in excess of normal trading volume. Pleasingly, almost all of the bonds traded in and around market pricing and the selling bulge was able to be digested in an orderly fashion.

In addition, primary issuance remained robust well into December with spreads generally flat, albeit after widening significantly over the course of 2022.

Sector Performance & Fund Positioning

Fund Positioning & Activity

We have spent 2022 reducing risk in our portfolios in response to the macro-economic challenges discussed in this update and previous Alexander Perspectives. The reduction in risk is highlighted by some key portfolio metrics including;

Credit Duration – lower portfolio credit duration is indictive of a lower exposure to the market deteriorating overall. During the year through a combination of trading and reinvesting proceeds from maturities into shorter dated assets, the credit duration within our portfolios was reduced to all time lows; and

Credit Quality – higher rated credit will generally outperform in difficult macro environments because of its lower probability of default. The average credit rating in both portfolios rose in 2022, particularly in RMBS/ABS markets where any new securities have been focused in the AAA portion of new deals.

Entering 2023, we believe this remains the prudent course of action until we get clarity on the full impact of rising rates on growth and the domestic consumer.

At Alexander Funds we have the benefit of being able to invest across the entire credit spectrum and find opportunities that allow us to construct portfolios with a conservative positioning on risk but healthy yields, with a margin in excess of the current cash rate consistent with history.

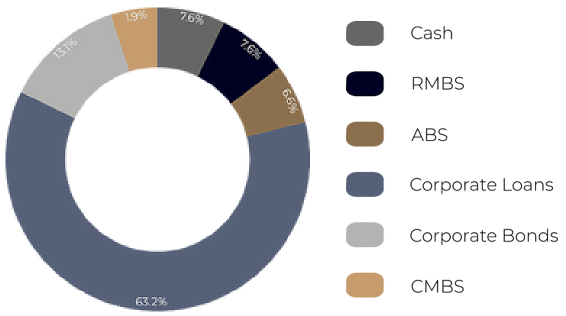
Fund Perfomance

Credit Opportunities Fund

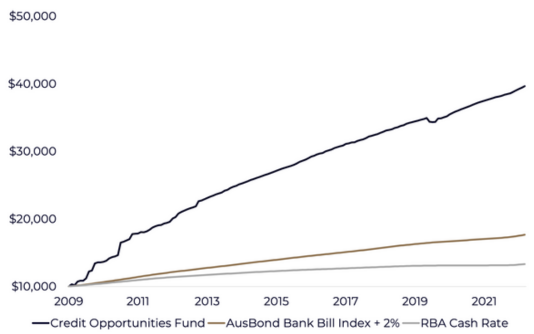
The Alexander Credit Opportunities Fund has a benchmark of the AusBond Bank Bill Index +2% pa. The Fund achieved a net return of 1.61% for the quarter ended 31 December 2022 for an annualised net return over the previous 12 months of 5.03%, and paid a distribution for the quarter of 2 cents per unit.

	Fund	Benchmark
1 Month*	0.61%	0.42%
3 Month	1.61%	1.25%
6 Month	3.03%	2.19%
12 Month	5.03%	3.30%
3 Year (pa)	4.59%	2.58%
Since Inception (pa)	11.03%	4.41%

Portfolio˜ as at 31 December 2022



Performance of $10k Invested Since Inceptionˆ

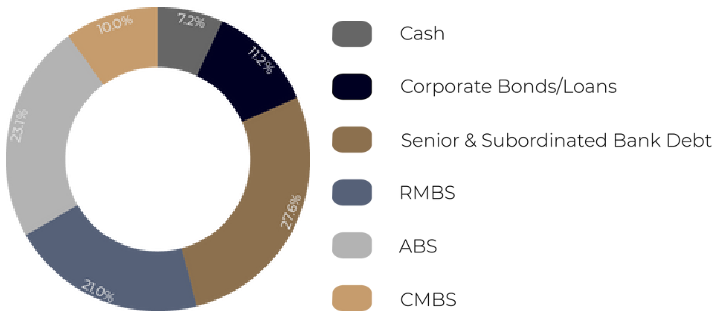


Credit Income Fund

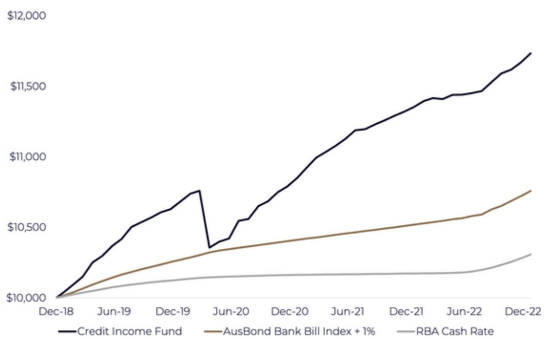
The Alexander Credit Income Fund has a benchmark of the AusBond Bank Bill Index + 1% pa. The Fund achieved a net return of 0.56% for the quarter ended 31 December 2022 for an annualised net return over the previous 12 months of 3.35%, and paid a distribution for the quarter of 1 cent per unit.

	Fund	Benchmark
1 Month*	0.56%	0.34%
3 Month	1.30%	1.00%
6 Month	2.47%	1.68%
12 Month	3.35%	2.27%
3 Year (pa)	3.18%	1.56%
Since Inception (pa)	3.99%	1.81%

Portfolio˜ as at 31 December 2022



Performance of $10k Invested Since Inceptionˆ



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Notices & Disclaimers

* The monthly return is an actual return net of all fees, costs and taxes generated by dividing the redemption unit price by the previous month's redemption unit price. Past performance is not a reliable indicator of future performance. All return figures for periods greater than 12 months are annualised.
~ Portfolio Composition is net of hedges
^ Assumes reinvestment of all distributions

Alexander Funds Management Pty Ltd (ABN 77 136 871 924) (AFSL 476697) ("Alexander Funds") is the Investment Manager of the Alexander Credit Opportunities Fund (ARSN 156 026 514) ("ACOF" or "Fund") and the Alexander Credit Income Fund (ARSN 629 915 199) ("ACIF" or "Fund"). Equity Trustees Limited ('Equity Trustees) (ABN 46 004 031 298) AFSL 240975 is the Responsible Entity for the Fund. Equity Trustees is a subsidiary of EQT Holdings Limited ABN 22 607 797 615, a publicly listed company on the Australian Securities Exchange (ASX: EQT).

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ACIF's PDS and TMD can also be found at
https://www.alexanderfunds.com.au/alexander-credit-income-fund
ACOF's PDS and TMD can also be found at
https://www.alexanderfunds.com.au/alexander-credit-opportunities-fund

A Target Market Determination is a document which is required to be made available from 5 October 2021. We recommend that you read this document as it describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.

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